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FENNEMORE CRAIG, P.C.
Norman D. James (No. 006901)
Jay L. Shapiro (No. 014650)
3003 N. Central Avenue
Suite 2600
Phoenix, Arizona 85012
Attorneys for Chaparral City
Water Company, Inc.

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF CHAPARRAL CITY WATER COMPANY, INC., AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.	DOCKET NO. W-02113A-07-0551

Arizona Corporation Commission
DOCKETED
FEB 27 2009
DOCKETED BY

CHAPARRAL CITY WATER COMPANY, INC.

REPLY BRIEF

(COST OF CAPITAL AND RATE OF RETURN)

FEBRUARY 27, 2009

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2009 FEB 27 P 4: 45
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Chaparral City uses the following abbreviations in citing to the pre-filed testimony and hearing transcripts in this brief. Other documents that were admitted as exhibits during the hearing are cited by hearing exhibit number (e.g., Ex. A-11). The parties' final schedules setting forth their respective final positions will be cited in abbreviated format as follows: Company Final Sch. XXX, Staff Final Sch. XXX; and RUCO Final Sch. XXX.* Other citations to testimony and documents are provided in full, including (where applicable) the Corporation Commission's docket number and filing date.

	Hearing Exhibit	**Abbreviation**
Direct Testimony (Cost of Capital) of Thomas J. Bourassa	**A-19**	Bourassa Dt.
Rebuttal Testimony (Cost of Capital) of Thomas J. Bourassa	**A-20**	Bourassa Rb.
Rejoinder Testimony (Cost of Capital) of Thomas J. Bourassa	**A-21**	Bourassa Rj.
Supplemental Rejoinder Testimony (Cost of Capital) of Thomas J. Bourassa	**A-18**	Bourassa Supp. Rj.
Direct Testimony of William Rigsby	**R-6**	Rigsby Dt.
Direct Testimony of Marlin Scott, Jr.	**S-1**	Scott Dt.
Direct Testimony Of Gordon Fox	**S-5**	Fox Dt.
Direct Testimony of Pedro Chaves	**A-16**	Chaves Dt.
Surrebuttal Testimony of David Parcell	**S-7**	Parcell Sb.
Hearing Transcript	**N/A**	Tr.

* Chaparral City filed corrected Final Schedules on February 13, 2009, which corrected an inconsistency concerning the utility's final position on rate case expense. Chaparral City's final position on cost of capital is unaffected by this correction, and the specific schedules relevant to the cost of capital have not been modified.

I. INTRODUCTION AND SUMMARY OF THE ISSUES

In this rate case, Staff, RUCO and Chaparral City agree that the Commission must use the Company's fair value rate base to determine its revenue requirement, in accordance with Arizona law.[1] The parties also agree that a fair rate of return on the fair value rate base should be commensurate with returns expected to be earned by enterprises with comparable risk and be sufficient to allow Chaparral City to attract capital on reasonable terms. This is, of course, the standard adopted in *Bluefield Waterworks*, one of the leading fair value cases.[2] Finally, all of the parties agree that the rate of return should be developed by using a cost of capital approach.

Unfortunately, the parties do not agree on the cost of equity or on how it should be determined. To complicate matters, the methods and inputs that the Commission has consistently used to determine the cost equity apparently are being called into question by Staff, even though in prior rate cases (including Chaparral City's prior case) Staff has always recommended the adoption of those methods. And in prior rate cases, Staff's recommendations were always adopted, even when the water utility presented the testimony of a national expert on the cost of capital and presented methods and inputs used by other regulatory commissions.[3] Finally, the parties still disagree about what to do with the cost of equity (and the overall cost of capital) once the cost of equity has been determined.

The resolution of these issues will have a substantial impact on the outcome of this rate case. The difference in operating income between the Company and Staff is $664,860, while the difference in operating income between the Company and RUCO is

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[1] *See, e.g., Chaparral City Water Co. v. Ariz. Corp. Comm'n*, No. 1 CA-CC 05-0002, Mem. Decision (Feb. 13, 2007) at 11-12, ¶ 14 ("*Chaparral City*").

[2] *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679, 692-93 (1923).

[3] *See, e.g.*, Rebuttal Testimony of Thomas M. Zepp, Docket No. W-02113A-04-0616 at 3-12 (April 20, 2005).

$1,009,612.[4] Because of the significance of these issues, Chaparral City's closing brief contained a summary of the procedural history of this case as well as a detailed discussion of the legal framework that governs the use of fair value to set rates and the appropriate rate of return in a fair value context. The Company's capital structure, cost of debt and cost of equity were also discussed in detail, along with the deficiencies (both conceptual and evidentiary) in the positions advocated by Staff and RUCO.

Chaparral City identified three overriding issues that must be addressed in the cost of capital/rate of return phase of this rate case, based on the evidence presented by the parties:

1. What is the "basic" cost of equity for Chaparral City, i.e., the estimated equity cost of the sample utilities used by the parties?
2. Is a downward adjustment to the cost of equity for financial risk appropriate?
3. Should the weighted cost of capital ("WACC") be used as the rate of return, or should the WACC be adjusted downward to account for inflation?[5]

The Company's reply will focus on only the first and third issues. Staff's Final Schedules show that Staff's final position is based on a cost of equity of 11.9 percent that is adjusted downward by an 180 basis points, resulting in a 10.1 percent cost of equity.[6] Yet Staff made no effort in its brief to defend this extraordinary adjustment. In fact, Staff presented no evidence or authority addressing the Company's testimony and the

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[4] *Compare* Staff Final Sch. Rev. MEM-1 *and* RUCO Final Sch. TJC-1 *with* Chaparral City's Corrected Final Sch. A-1.

In this reply brief, the Company will also use the same citation format, abbreviations and conventions as utilized in its cost of capital closing brief dated February 13, 2009. The Company will also refer to that closing brief as Company COC Br., and to the other parties' cost of capital briefs as Staff COC Br. and RUCO COC Br., respectively.

[5] Company COC Br. at 2-4.

[6] Staff Final Sch. PMC-3 (showing how Staff's recommended 10.1 percent cost of equity was determined, including a 1.8 percent negative adjustment for "financial risk").

authorities the Company has cited.[7] Consequently, the Company's evidence that Staff incorrectly implemented the Hamada Equation by using book values rather than market values and that Staff's adjustment conflicts with prior Commission decisions is undisputed, and Staff's financial risk adjustment must be rejected.

On the two other issues, the Company stands by its recommended cost of equity of 11.5 percent, which results in a weighted average cost of capital ("WACC") of 9.96 percent. That cost of equity is less than Staff's final cost of equity estimate of 11.9 percent, and is less than the Company's final cost of equity estimate of 12.7 percent. The Company used same market-based finance models – the DCF model and the CAPM – that the Commission has approved in numerous water and wastewater utility rates during the past eight years (including Chaparral City's prior case).[8] Moreover, the methods and inputs used by Staff and the Company are similar in many respects. Staff and the Company rely on the same sample group of six publicly traded water utilities, which are the utilities that have been used by the Commission in setting rates for water and wastewater utilities for a number of years (including Chaparral City's last rate case).[9] As a result, the cost of equity estimates of Staff and the Company are similar. Accordingly, the Company's recommended 11.5 percent equity cost is certainly reasonable.

The Company also maintains that the WACC should be used as the rate of return, without further adjustment because it is being applied to a fair value rate base. Under the fair value standard, rates must be set "according to the actual present value of the assets employed in the public service."[10] Utility investors are rewarded "with an opportunity to earn an 'above-cost' return" when the value of their assets increases, but must bear the

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[7] *See* Company COC Br. at 51-56; Bourassa Rb. at 28-35; Bourassa Rj. at 13-15.

[8] Decision No. 68176 at 17-26.

[9] Bourassa Rj. 12-13.

[10] *Duquesne Light Co.*, 499 U.S. 299, 308 (1989).

burden when the value declines.[11] Moreover, the Arizona Supreme Court has explained that the "reasonableness and justness of the rates must be related to [the] finding of fair value."[12] The cost of capital methodology can be used to derive this rate of return,[13] using finance models such as the DCF model and the CAPM that rely on market data and do not consider the rate bases of the publicly traded sample utilities.[14]

When the WACC is applied to the rate base, it is implicitly assumed that the utility's invested capital is financing that particular rate base, just as in a competitive market, the investment in an asset (e.g., a parcel of land or shares of common stock) is financing that asset regardless of the asset's current value. The asset's value is based on various economic factors, not simply the amount originally paid for it. If the asset is appropriated for a public use, the investor is compensated on the basis of the asset's current value, not on what she originally paid for the asset. The fair value standard works the same way, as the courts have held. By allowing utility investors to be rewarded when the value of their property increases, but requiring them to bear the burden when its value decreases, the "fair value standard mimics the operation of the competitive market,"[15] which, as RUCO has acknowledged, is "[t]he goal of regulation."[16]

Finally, the Company continues to assert that it is improper rate-making to adjust the cost of capital for "inflation" while ignoring the pernicious impact of inflation on the

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[11] *Id.* at 308-09. *See also McCardle v. Indianapolis Water Co.*, 272 U.S. 400, 410-11 (1926) ("It is well established that values of utility properties fluctuate, and that owners must bear the decline and are entitled to the increase."); *Bluefield Waterworks*, 262 U.S. at 690 ("If the property, which legally enters into the consideration of the question of rates, has increased in value since it was acquired, the company is entitled to the benefit of such increase.").

[12] *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378 382 (1956).

[13] *See, e.g., State ex rel. Utilities Comm'n v. Duke Power Co.*, 206 S.E.2d 269, 281 (N.C. 1974); *City of Alton v. Commerce Comm'n*, 165 N.E.2d 513, 519 (Ill. 1960).

[14] Bourassa Rb. at 11-14.

[15] *Duquesne Light,* 488 U.S. at 308.

[16] RUCO COC Br. at 11.

remainder of the Company's cost of service. The Company also believes that Staff and RUCO's recommended adjustments to the WACC are overstated because original cost is, by definition, not subject to inflation, and neither is the Company's cost of debt, which does not change in response to the general level of inflation in the economy. The cost of debt is akin to an operating expense that is fixed and must be paid in accordance with the terms of the Company's debt instruments.

Staff and RUCO disagree with the Company on many of these points. Staff, unfortunately, appears to disagree with itself, while Staff and RUCO also disagree with each other on certain key points, including the inputs used in the DCF and CAPM and whether inflation affects the original (historic) cost of utility plant. These areas of disagreement are addressed below.

II. ISSUE ONE: THE "BASIC" COST OF EQUITY FOR CHAPARRAL CITY IS NO LESS THAN 11.5 PERCENT

A. Staff's Cost of Equity: What Is Really Going On Here?

Staff's Final Schedules state that Staff's "final" recommended cost of equity is 10.1 percent.[17] Staff reached this recommended cost of equity based on the average of its DCF and CAPM models, less a financial risk adjustment:

$$\frac{9.5\%\ (\text{DCF}) + 14.3\%\ (\text{CAPM})}{2} = 11.9\% - 1.8\% = 10.1\%^{18}$$

Staff made no effort to defend this cost of equity determination in its brief. Instead, to justify a "10 percent" return on equity, Staff relied almost exclusively on its second cost of capital witness's criticism of its first cost of capital witness's use of the CAPM in the face of current market conditions.[19] For example, Staff asserted in its brief

[17] Staff Final Sch. PMC-1, PMC-3.

[18] Staff Final Sch. PMC-3.

[19] Staff COC Br. at 5-8.

that "the Company's methods to derive its cost of equity ignore the realities of the current market conditions."[20] But the methods used by the Company are very similar to those used by Staff, and those methods produce similar cost of equity estimates, both of which are higher than the Company's recommended cost of equity of 11.5 percent. For example, Staff's final CAPM estimate is 14.3 percent, while the Company's final CAPM estimate is 14.0 percent.[21] So Staff is really attacking its own final position in the case. It is unclear whether Staff's confusion is a deliberate attempt to muddle the issues or is the result of carelessness. In any case, Staff's justification for ignoring its own position is unsupported by the record.

1. Mr. Parcell's Testimony Was Contradictory and Conclusory, and Should Be Disregarded

On October 3, 2008, Staff filed its direct testimony recommending a cost of equity of 10.0 percent based on the same methodology as its Final Schedules.[22] Staff's cost of equity was determined using the same methodology approved for the Company in Decision No. 68176 (and affirmed on appeal[23]), but with a downward adjustment for financial risk based on the Hamada Equation.[24] Notably, this cost of capital analysis was prepared using data obtained before the significant drop in the stock market and worsening of the economy that occurred in late 2008.[25] Thus, Staff's 11.8 percent cost of equity estimate was not affected by recent changes in market conditions.

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[20] Staff's COC Br. at 6.

[21] *See* Company Final Sch. D-4.13; Staff Final Sch. PMC-3.

[22] *E.g.*, Chaves Dt. at 34-35. Staff later corrected the average of Mr. Chaves' DCF to 9.5 percent (Tr. at 757), increasing Staff's final unadjusted cost of equity to 10.1 percent. *See* Staff Final Sch. PMC-3.

[23] *Chaparral City* at 14-28, ¶¶ 18-48.

[24] *Compare* Chaves Dt. at 7-35 *with* Decision No. 68176 at 21-26.

[25] *See* Chaves Dt. at 15 and n. 4, 28, 36. The data used by Mr. Chaves was from late July and early August, 2008.

Staff didn't timely file surrebuttal testimony regarding the cost of equity. Rather, Staff simply ignored the deadline and, a day later, moved to late file the surrebuttal testimony of a substitute cost of capital witness, David Parcell. Staff contacted Mr. Parcell in November as a result of declines in the stock market that occurred in mid-October 2008 – after Mr. Chaves' testimony was filed.[26] No witness testified that Mr. Chaves' methods and inputs were distorted or unrealistic, nor could they given that Mr. Chaves used data from early August 2008. In fact, Mr. Fox testified that Staff's methods are sound.[27] Mr. Parcell himself admitted that he testified in a water utility rate case before the Delaware Public Service Commission in December, and that neither he nor any of the other cost of capital witnesses changed their recommendations to account for events that occurred in late 2008.[28]

Nevertheless, according to Staff, Mr. Parcell's testimony was necessary "because of the unique volatility of the U.S. financial markets."[29] But Mr. Parcell was not brought in to quantify the impact of this market volatility on the current cost of equity, as one would expect. Instead, when questioned about Staff's recommended return on equity, Dr. Parcell simply testified that an end result of 10 percent was the "same as his recommendation" and "reasonable" to him so he just went along with Staff's "bottom line" number.[30] Mr. Parcell filed no schedules, provided no work papers showing how he actually arrived at a 10.0 percent cost of equity, and adopted portions of Mr. Chaves' testimony and schedules, while striking others.[31]

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[26] Tr. at 546-47, 761-62.

[27] Tr. at 490, 491-92.

[28] Tr. at 784.

[29] *Id.*

[30] Tr. at 757-58.

[31] *E.g.*, Tr. at 757; Ex. S-8.

Moreover, Mr. Parcell's testimony was internally inconsistent and contradicts Staff's final position on the cost of capital. For example, while Mr. Parcell criticized Staff's method of estimating the current market risk premium for the CAPM, he also defended Staff's current market risk premium estimate in response to the Company's testimony that Staff's method is unstable, explaining that [c]hanges in Staff's market risk premium results over time are a reflection of changes in the market's current risk premium rather than instability in Staff's method."[32] Likewise, while Mr. Parcell testified that economists' forecasts of inflation are a better indicator of future inflation than spot yields on Treasuries, he also testified that professional forecasts of financial variables are "notoriously unreliable" and that the direction of interest rates "cannot be predicted any better than by the flip of a coin."[33] Which one is it? We simply don't know.

Mr. Parcell further testified:

> Staff used U.S. Treasury securities' spot rates on August 6, 2008, to correspond with the date Staff selected the sample companies' stock spot prices. Use of the current bond yield is consistent with finance theory, i.e., the efficient market hypothesis. Further, as explained in Section X of this testimony, the best estimate of tomorrow's yield is simply today's yield.[34]

This testimony is the linchpin of Staff's inflation estimate, which was used by Mr. Fox to support his adjustment to the cost of capital.[35] Yet in its brief, Staff asserts that Mr. Parcell testified that spot prices should not be used.[36] Again, which one is it? Is the

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[32] Ex. S-8 at 44. *Compare* Staff COC Br. at 8 (discussing Mr. Parcell's concerns with Staff's current market risk premium estimate).

[33] *Id.* at 44 (quoting Steven G. Kihm, "The Superiority of Spot Yields in Estimating Cost of Capital," *Public Utilities Fortnightly* 42-45 (Feb. 1, 1996)). *Compare* Staff COC Br. at 8 (arguing that forecasts of inflation should be used).

[34] *Id.* at 37.

[35] *See id.* at 36-37; Fox Dt. at 8.

[36] Staff COC Br. at 7.

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method Staff used to estimate inflation valid or invalid? If it is invalid, then Staff's inflation adjustment must be rejected.

Boiled down, Mr. Parcell adopted both sides of a number of issues, which can hardly be described as a "reasoned approach." Instead, this testimony raises questions about his credibility as a witness, which may be why Staff, in its Final Schedules, has gone back to Staff's prior cost of equity estimate and has ignored Mr. Parcell's unhelpful "critique" of Staff's methods and inputs. Given that those schedules reflect Staff's final positions, and given the vague and inconsistent testimony presented by Mr. Parcell, Mr. Parcell's testimony should be disregarded.

2. Staff's Criticisms of the Company's Equity Cost Estimates Are Unfounded

Staff has attacked the Company for "ignoring the realities of the current market conditions."[37] As explained above, however, Staff's recommended cost of equity did not change as a result of volatility in the markets. Staff's initial estimate of the cost of equity was based on data from last summer, before the major downturn in the stock market in late 2008. Mr. Chaves estimated that the cost of equity for the sample water utilities was 11.8 percent in his direct testimony, while Staff's final position is that the cost of equity is 11.9 percent. Thus, Staff did not account for volatile market conditions, nor was there any reason to do so given that the Company's recommended cost of equity is below Staff's initial estimate.[38] For this reason, Mr. Parcell's testimony was also irrelevant.

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[37] *Id.*

[38] As previously explained, the difference between the Company's recommended equity cost of 11.5 percent and Staff's recommended equity cost of 10.1 percent is Staff's downward adjustment of 180 basis points for financial risk based on the Hamada Equation. Staff Final Sch. PMC-3. The Hamada Equation is an extension of the CAPM that isolates a firm's beta into business risk and financial (capital structure) risk components. *See, e.g.*, Roger A. Morin, *New Regulatory Finance* 223-24 (Public Utility Reports, Inc. 2006) ("*Morin*"); Richard A. Brealey, Stewart C. Myers and Franklin Allen, *Principles of Corporate Finance* 516-20 (McGraw Hill/Irwin 8th ed. 2006). It has nothing to do with market volatility.

Staff also argues that the Company's "own analysis supports Staff's position that the use of the standard models in this economic climate yields skewed results."[39] First, and obviously, Staff's final position is based on those same models, the DCF and the CAPM, and its final equity cost estimate didn't change as a result of the economic climate. Nevertheless, Staff asserts that the markets must be unusually volatile because the Company's DCF estimate changed by 40 basis points and its CAPM estimate changed by 70 basis points in the 27-day interval between the Company's rejoinder testimony and its supplemental rejoinder testimony.[40] This is simply nonsense. In Chaparral City's prior rate case, Staff's CAPM estimate changed by 70 basis points and its overall cost of equity estimate changed by 40 basis points in the 44-day interval between Staff's direct testimony and its surrebuttal testimony.[41] In Gold Canyon Sewer Company's prior rate case, Staff's DCF estimate changed by 50 basis points, its CAPM estimate changed by 150 basis points, and its cost of equity estimate changed by 100 basis points in the 75-day interval between Staff's direct testimony and its surrebuttal testimony.[42] In neither instance were the financial markets especially volatile.

The bottom line is that the DCF and CAPM use a variety of different inputs, and those inputs may change during a relatively short period of time, producing equity cost estimates that are quite different. If Staff's argument proves anything, it is that recent market volatility has little impact on the results produced by the DCF and CAPM models. Certainly, the markets are riskier than in previous years, requiring a higher cost of equity than Chaparral City was authorized in its prior case to satisfy the attraction of capital

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[39] Staff COC Br. at 7.

[40] *Id.*

[41] Direct Testimony of Alejandro Ramirez, Docket No. W-02113A-04-0616 (March 22, 2005); Surrebuttal Testimony of Alejandro Ramirez, Docket No. W-02113A-04-0616 (May 5, 2005).

[42] Direct Testimony of Steven P. Irvine, Docket No. SW-02519A-06-0015 (June 16, 2006); Surrebuttal Testimony of Steven P. Irvine, Docket No. SW-02519A-06-0015 (August 30, 2006).

standard. But Staff conveniently overlooks the fact that other measures of investment risk, which are unrelated to current market volatility, have also changed over the past four or five years.

For example, investment risk as estimated by beta has increased dramatically during the past four years. "According to both financial theory and empirical evidence, betas are critical and sufficient measures of risk."[43] Beta measures a security's volatility relative to the market as a whole, and the cost of equity moves in the same direction as beta.[44] In Chaparral City's prior rate case, the average beta of Staff's sample group of water utilities was 0.68.[45] The average beta of those same utilities is now 1.01 as shown in Staff's Final Schedules.[46] That is an increase in risk, as estimated by beta, of nearly 50 percent. To put that increase in context, if the average beta of Staff's sample group had been 1.01 in Chaparral City's prior rate case (when market volatility was not a concern), Staff's CAPM estimate would have increased by <u>260 basis points</u>, from 9.2 percent to <u>11.8 percent</u>. Staff's overall cost of equity would have increased by 130 basis points, from 9.3 percent to <u>10.6 percent</u>.[47]

Thus, regardless of the market's volatility, water utilities have become significantly more risky relative to other securities traded in the market, and their cost of equity has increased accordingly. Staff ignored this increase in risk in its brief, as well as the impact of current market conditions on the Company's ability to attract capital. Staff's one-sided argument is not well reasoned but result-driven.

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[43] *Morin* at 81.

[44] Ex. S-8 at 9-11.

[45] Surrebuttal Testimony of Alejandro Ramirez, Docket No. W-02113A-04-0616 (March 22, 2005).

[46] Staff's Final Sch. PMC-3. *See also* Ex. S-8 at 9.

[47] *See* Surrebuttal Testimony of Alejandro Ramirez, Docket No. W-02113A-04-0616 (March 22, 2005) at Sch. AXR-8.

In reality, the Company has presented a reasoned recommendation that takes into account prevailing market conditions and increases in the relative riskiness of the water utility sample, using methods similar to those Staff has recommended and the Commission has approved in numerous water and wastewater utility rate cases. Most critically, although Mr. Bourassa's estimate of the cost of equity exceeded 11.5 percent,[48] the Company has not requested that the Commission authorize a higher cost of equity. As Mr. Bourassa explained:

> The Company has elected to request a return of 11.5 percent on common equity. As I explained in my rebuttal testimony, the Company is willing to do so in order to minimize disputes and to keep the revenue increase at or below the increase requested in its direct filing. The Company realizes that an equity return of 13 percent would be controversial, even if it is indicated by the financial models and methods that have been used by Staff and approved by the Commission in numerous water and wastewater utility rate cases during the past six or seven years. The Company hopes to avoid a dispute over the cost of equity and to simplify this case, which has already been pending for more than 14 months.[49]

Therefore, the Company is not proposing to benefit from the condition of the capital markets or the current state of the economy, as Staff claims. Instead, it appears that Staff is improperly using market volatility as an excuse to ignore the results of its own analysis. Staff's position is nothing more than the proverbial "heads I win, tails you lose" approach, under which Staff relies on its models and inputs to estimate the cost of equity as long as those models produce the result Staff wants. In the end, the Company's 11.5 percent cost of equity is reasonable, as is Staff's 11.9 percent cost of equity.

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[48] In his rebuttal testimony, for example, Mr. Bourassa's equity cost estimate was 13.0 percent. Bourassa Rb. at 2. In his rejoinder testimony, his estimate was 13.2 percent. Bourassa Rj. at 2.

[49] Bourassa Rj. at 9.

B. RUCO's Methods and Inputs Are Theoretically Unsound, in Conflict With Prior Commission Decisions, and Are Intended to Depress the Cost of Equity

In its opening brief, Chaparral City identified and discussed five serious problems concerning RUCO's 8.83 percent cost of equity estimate. Those problems, in summary, are:

1. RUCO's sample group of publicly traded water utilities excluded three utilities normally used by Staff and the Commission, Connecticut Water Service, Middlesex Water Company and SJW Corporation, and instead included Southwest Water Company. Southwest Water, however, is not comparable to Chaparral City or to sample water utilities because a majority of its revenues are derived from unregulated activities, and it is a financially sick utility, which depresses the cost of equity.[50]

2. RUCO also used a group of gas distribution utilities as comparable firms, even though RUCO's gas utility sample has an average beta of 0.82, while RUCO's water utility sample has an average beta of 1.05. The water utility sample has significantly more systematic (market) risk than the gas utility sample, and cannot be used to estimate Chaparral City's cost of equity unless an adjustment is made to account for the difference in risk. RUCO proposed no such adjustment.[51]

3. RUCO's estimate of dividend growth (using the sustainable growth method) in its DCF equity cost estimate relied on a variety of different forecasts and projections, and cannot be replicated or verified. Instead, it was highly subjective, and was well below the sustainable growth estimates of Staff and the Company.[52]

4. RUCO's CAPM estimates were flawed due to its erroneous calculation of the risk premium. In addition to using erroneous sample utilities, RUCO made three significant mistakes: (1) RUCO incorrectly used a geometric mean to calculate the market risk premium; (2) it incorrectly used two different Treasury securities as its proxy for the risk-free rate of return; and

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[50] Company COC Br. at 33-36. Notably, the Commission has never approved the use of Southwest Water as a sample water utility.

[51] *Id.* at 36-37.

[52] *Id.* at 37-39.

(3) it incorrectly used the <u>total</u> return on the "riskless" Treasury security in calculating the equity risk premium rather than the income return.[53]

5. RUCO completely ignored current market risk. Staff has consistently recommended, and the Commission has consistently approved, the use of a current market risk premium in implementing the CAPM in water and wastewater utility rate cases, including Chaparral City's prior case. Moreover, changes in the current market risk premium have been a significant factor in the cost of equity authorized by the Commission for water and wastewater utilities, offsetting changes in interest rates and water utility betas in recent cases.[54]

In its brief, RUCO referenced certain of these issues, but failed to accurately describe the Company's evidence and argument. Accordingly, the Company will briefly address RUCO's major arguments.

1. RUCO's Failure to Consider Current Market Risk Was Improper and Conflicts With Prior Commission Decisions

To justify its failure to consider current market risk, RUCO argues that "[r]eliance on past performance is more sound than reliance on analysts projections of market returns and treasury yields."[55] This argument is irrelevant, however. The CAPM estimates of Staff and the Company do not rely in any way on analysts' forecasts. Mr. Rigsby, however, relied on analysts' projections of future earnings and dividend growth in his DCF estimates.[56] Under RUCO's argument, therefore, Mr. Rigsby's DCF estimate should not be considered.

RUCO also relies on testimony given by Mr. Parcell about the use of a current market risk premium at the present time. This argument overlooks the fact that

53 *Id.* at 39-46.

54 *Id.* at 46-49.

55 RUCO COC Br. at 3.

56 Rigsby Dt. at 24-27.

notwithstanding Mr. Parcell's disagreement with Staff, Staff's final schedules are based on Mr. Chaves' testimony (with the exception of correcting an error found by Mr. Parcell) and not on Mr. Parcell's testimony,[57] and that Staff's use of a current market risk premium is consistent with prior water and wastewater utility rate cases.[58] As Staff argued in another recent rate case, "[t]he [market risk premium] moves with the market which can be volatile. Market volatility does not make the CAPM model unstable or subject to manipulation."[59] Staff "uses both an historical [market risk premium] and a current [market risk premium] to mitigate the market's volatility."[60] And as previously discussed, Mr. Chaves' direct testimony was filed on October 3, 2008, i.e., <u>before</u> the financial markets became extremely volatile. In fact, the current market risk premium in Staff's Final Schedules, 12.6 percent, is <u>lower</u> than the 13.1 percent current market risk premium used in Arizona Water Company's Eastern Group case.[61]

RUCO claims that the use of a market risk premium in the CAPM is "refuted" by Value Line's forecasted equity return for the water utility industry.[62] As a preliminary matter, RUCO, on the same page of its brief, claims that analysts' forecasts are unreliable. Putting this inconsistency aside and assuming that forecasted returns on book equity are relevant,[63] RUCO's argument ignores the key information reported by Value Line – the

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[57] *Compare* Chaves Dt., Sch. PMC-3 *with* Staff Final Sch. PMC-3.

[58] *See* Company COC Br. at 46-48 (discussing how the current market risk premium has affected prior cost of equity estimates adopted by the Commission).

[59] Closing Brief of Commission Staff, *Black Mountain Sewer Corp.*, Docket No. SW-02361A-05-0657 at 24 (attached to Bourassa Supp. Rj. at tab 3).

[60] *Id.* at 25.

[61] Direct Testimony of Joel M. Reiker, Docket No. W-01445A-02-0619 at 24, 25 (July 8, 2003). *See also* Bourassa Supp. Rj. at 15-16 (explaining why Mr. Parcell's argument against the use of a current market risk premium lacks validity).

[62] RUCO COC Br. at 3-4.

[63] In prior cases, the Commission has rejected the use of returns on book equity in estimating the cost of equity and instead relies on market-based models, such as the DCF and the CAPM. *See* Bourassa Rb. at 12-13.

projected equity returns for the utilities in RUCO's sample group. The projected returns on equity for American States Water, Aqua America and California Water Service average 12.2 percent for the five year period through 2013.[64] Even if Southwest Water is included, average return on equity is still 11.3 percent. These projections are consistent with the Company's 11.5 percent cost of equity and Staff's 11.9 percent unadjusted cost of equity. They are not consistent with RUCO's 8.83 percent cost of equity.

2. RUCO Improperly Used a Geometric Mean (Average) in Determining Its Historic Market Risk Premium

RUCO has misstated the reason why a geometric mean (average) should not be used to estimate the historic market risk premium and, more generally, the cost of equity. A geometric mean is the correct method to express what has happened in the past. But it fails to capture the variability of past returns, and therefore understates the risk associated with the market. The use of an arithmetic mean is theoretically correct because "the arithmetic mean recognizes the uncertainty in the stock market while the geometric mean removes the uncertainty by smoothing over annual differences."[65]

Consequently, the geometric mean is an "industry standard" that is widely reported because it accurately describes past performance.[66] But this does not mean that a geometric mean should be used to estimate the cost of equity, as numerous experts have explained.[67] RUCO is effectively arguing that if an investor has information available and is not sophisticated enough to use that that information correctly, such information nevertheless should be used to determine a utility's cost of equity.[68] Under this logic, it

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[64] Ex. R-14.

[65] *Morin* at 134 (attached to Bourassa Rj. at tab 3).

[66] RUCO COC Br. at 4.

[67] *See Morin* at 133-43 (discussing numerous studies and authorities addressing this issue) (attached to Bourassa Rj. at tab 3).

[68] Bourassa Supp. Rj. at 18.

would be appropriate to use Value Line's projected 12.2 percent average return on equity for American States Water, Aqua America and California Water in determining Chaparral City's cost of equity because that information is publicly reported by a reputable source and widely known by investors. Yet RUCO has not done so.

RUCO also argues that the 7.5 percent historic market risk premium used by Staff and the Company is too high, claiming that recent research suggests the market risk premium is actually lower, and the use of a geometric mean properly depresses the market risk premium and resulting rate of return.[69] Both Staff and the Company used the arithmetic mean published in the *2008 Ibbotson SBBI Valuation Edition Yearbook* (Morningstar 2008) ("*Ibbotson*"[70]), which calculates the historic risk premium by averaging the historic arithmetic differences between the S&P 500 and intermediate-term government bond income returns for the period 1926 through 2007.[71] RUCO has presented no evidence that *Ibbotson*'s calculations are erroneous.

Instead RUCO quotes from a text (which happens to recommend the use of an arithmetic mean in the CAPM[72]) explaining that "[h]istorical estimates found in most textbooks" are too high due to the use of "short-term bonds, use on [sic] 75 years of data, and are biased by the historical strength of the U.S. market."[73] Here, in contrast, the risk premium is not being computed with short-term bonds and more than 75 years of data are used from a reliable source – *Ibbotson* – rather than a textbook. And the fact that over the past century, the United States stock market has outperformed markets in foreign countries such as Poland and China is irrelevant. In this case, the Company's cost of

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[69] RUCO COC Br. at 5.

[70] Relevant portions of *Ibbotson* have been reproduced at tab 4 of Bourassa Supp. Rj.

[71] Chaves Dt. at 30; Bourassa Dt. at 35-36.

[72] Bourassa Rj. at 26-27.

[73] RUCO COC Br. at 5.

equity is being estimated by using a sample group of publicly traded water utilities in the United States, which are treated as being comparable in terms of investment risk. It would be improper to reduce the historic risk premium to account for a higher incidence of business failures in foreign countries.[74]

3. RUCO's Use Of Southwest Water and the Gas Distribution Utilities as Proxies for Chaparral City Was Erroneous

In its initial brief, Chaparral explained in detail why Southwest Water should not be used as a proxy for Chaparral City, and why the gas utilities are not comparable. RUCO's brief provides no new evidence or argument showing otherwise.

As an initial matter, it is important to keep in mind that the sample group of water utilities is not the Company's sample group. Rather, those water utilities have been consistently used by Staff and approved by the Commission in numerous water and wastewater utility rate cases during the past six or seven years, including Chaparral City's prior rate case. Conversely, the Commission has never used Southwest Water, nor has the Commission ever excluded Connecticut Water Service, Middlesex Water Company and SJW Corporation. RUCO has provided no legitimate reason for the Commission to depart from its prior practice.

RUCO has not disputed that its use of Southwest Water depresses the cost of equity; instead, it justified the use of Southwest Water by comparing it to American States Water, Chaparral City's parent.[75] This effort fails. Southwest Water derives less than 45 percent of its revenues from regulated activities, including services like infrastructure construction and management of public works services. By comparison, 86 percent of American States' revenues and 96 percent of its net income in 2007 were generated by its

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[74] Bourassa Rj. at 27.

[75] RUCO COC Br. at 8.

principal subsidiary, Golden State Water Company, which also owns 92 percent of American States' assets.[76] These differences alone should be enough to exclude Southwest Water.[77]

RUCO ignored the evidence that Southwest Water is a financially troubled corporation. AUS Monthly Utility Reports (November 2008) reported that for the 12-month period ended June 30, 2008, Southwest Water had <u>negative</u> earnings per share, and its dividend pay out ratio, return on common equity and return on total capital were "not meaningful."[78] Value Line's October 2008 report is almost as bleak, reporting that in 2007, Southwest Water earned a 3.5 percent return on equity, and projecting returns of 3.5 percent and 5.0 percent – earnings well <u>below</u> the cost of debt – in 2008 and 2009, respectively.[79] As stated in the Company's opening brief, financially sick companies should not be used as proxies in estimating the cost of capital.[80]

The Commission rejected the use of gas companies as proxies for a water utility based on the difference between the average beta of the water utility sample group and average beta of the gas utility sample group in Arizona Water Company's Eastern Group rate case.[81] At that time, the average beta of the water utility sample group (0.59) was <u>lower</u> than the average beta of gas sample group (0.69), and according to Staff, a 100 basis point downward adjustment was needed to account for the difference in investment risk. Currently, however, the average beta of RUCO's water utility sample group (1.05)

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[76] Ex. R-13 at 18 (unnumbered).

[77] Tr. at 606-07; Bourassa Rj. at 28-29.

[78] Bourassa Rj. at 29.

[79] Ex. R-12 at 5 (unnumbered).

[80] *Sun City Water Co. v. Ariz. Corp. Comm'n*, 26 Ariz. 304, 310, 547 P.2d 1104, 1110 (App. 1976), *rev'd on other grounds*, 113 Ariz. 464, 556 P.2d 1126 (1976) ("Companies which are used for comparison purposes must be successful and not in a financially sick condition.").

[81] *Arizona Water Co. (Eastern Group)*, Decision No. 66849 at 21 (March 22, 2004).

is <u>higher</u> than the average beta of its gas sample group (0.82). Using Staff's approach, an upward adjustment of 250 basis points is required to reflect the cost of equity for a water utility like Chaparral City, as shown in the Company's initial brief.[82]

In the Arizona Water case, the use of the gas utility sample as a proxy for the water utility would have increased the cost of equity. Here, it has the opposite effect because the average beta of the gas utility sample is now less than the average beta for the water utility sample. This means that, as a group, the gas utility sample is less risky and has a lower cost of equity.[83] It would be arbitrary and capricious for the Commission to accept a downward adjustment to the gas utility sample's cost of equity when its average beta is higher than that of the water utility sample, but fail to adjust the gas utility sample's cost of equity upward when the reverse is true.

RUCO criticizes the Company for employing the analysis used in the Arizona Water rate case. According to RUCO, the correct approach is to consider accounting data and actual book returns paid (which would certainly exclude Southwest Water as a proxy given its negative earnings per share).[84] But the CAPM "describes the relationship between a security's investment risk and its market rate of return," and "assumes that investors require a return that is commensurate with the level of risk associated with a particular security," as Mr. Parcell testified.[85] The level of risk associated with a particular investment has been estimated exclusively by beta in prior rate cases. In the Company's prior rate case, for example, the Commission refused to consider any adjustment to the cost of equity based on firm-specific factors because "beta represents

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[82] Company COC Br. at 36-37.

[83] This undoubtedly explains why Mr. Parcell is now considering using gas utilities as proxies for water utilities. One suspects that his view would change, as would RUCO's, if the average beta gas utilities increases and become greater than the average beta of the water utilities.

[84] RUCO COC Br. at 6-8.

[85] Ex. S-8 at 26-27.

systematic risk of the industry, which is the only risk relevant to the cost of equity."[86]

In short, the Commission, not Chaparral City, has limited its cost of capital analysis to systematic risk as measured by beta. The Company would like the Commission to consider a wider range of factors that affect investment risk, such as those listed by RUCO.[87] But the Commission's focus has been far narrower, and it would be arbitrary to now allow RUCO to now expand that focus so that gas utilities can be used to drive down the cost of equity, as RUCO proposes.

4. RUCO's Cost of Equity Methodology Was Not Used In Chaparral City's Prior Case

RUCO's contention that its recommended cost of equity was determined based on the methodology used by the Commission in Decision No. 70441 is erroneous.[88] In fact, Chaparral City's cost of equity, 9.3 percent, was determined in Decision No. 69176 based on Staff's recommendation.[89] In that decision, RUCO's cost of equity recommendation was rejected.[90] The 9.3 percent cost of equity and the evidence supporting that cost of equity were affirmed on appeal.[91]

In the remand proceeding, the Commission began with the 9.3 percent cost of equity authorized in Decision No. 68176, but reduced it by 200 basis points for inflation. That adjustment, discussed in this next section, had nothing to do with the appropriate method of estimating the cost of equity. It was an after-the-fact adjustment intended to lower the rate of return to avoid over-compensating the Company for what the

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[86] *Chaparral City* at 27, ¶ 46.
[87] RUCO COC Br. at 7.
[88] *Id.* at 9-10.
[89] *See* Decision No. 68176 at 21-26.
[90] *Id.*
[91] *See Chaparral City*, at 14-27, ¶¶ 18-48.

Commission called "inflation."[92] Consequently, the cost of equity methods and inputs proposed by RUCO actually conflict with methods and inputs used to determine Chaparral City's 9.3 percent in Decisions No. 68176 and No. 70441, as well as other water and wastewater utility rate cases. The Commission rejected RUCO's methodology in Decision No. 68176, and should do so again in this case.

C. Chaparral City's Proposed Resolution

In light of the foregoing, the Company finds itself in the bizarre position of defending Commission practice and prior decision-making against Staff's confusion about its actual recommendation on the one hand and RUCO's attempt to manipulate the results of the DCF and CAPM on the other. Chaparral City's recommendation falls between the two other parties and is the only reasonable cost of equity, based on the evidentiary record and given the totality of the circumstances. It is also consistent with prior Commission decisions, as Mr. Bourassa pointed out,[93] and to the extent relevant, Value Line's projected returns on equity. Therefore, the Commission should authorize an 11.5 percent cost of equity in order to derive the Company's WACC. This cost of equity is realistic given the current volatility in the financial markets and the water utility sample group's current investment risk, as estimated by beta.

III. ISSUE TWO: THE WEIGHTED COST OF CAPITAL SHOULD BE USED AS THE RATE OF RETURN

The Company has argued, in the remand proceeding and in this case, that an inflation adjustment is unnecessary because fair value rate base is not the "inflated" cost of Chaparral City's plant.[94] In contrast, both Staff and RUCO argue that the rate of return

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[92] *See* Decision No. 70441 at 36-37.

[93] Bourassa Supp. Rj. at 26-27. *See also* Rebuttal Testimony of Thomas M. Zepp, Docket No. W-02113A-04-0616 at Rebuttal Table 2 (April 20, 2005) (authorized returns on equity prior to December 2001).

[94] Company COC Br. at 56-72.

must be adjusted downward to account for inflation. In short, their proposed adjustments are problematic in the following respects;

(1) The fact that, as Staff acknowledges, one-half of the Company's FVRB consists of its OCRB, which is based on the original or historic cost of the plant and is unaffected by changes in prices. An adjustment to the cost of equity that fails to recognize this fact dramatically overstates the impact of inflation.

(2) The Company's long-term debt is an existing contractual obligation that has a fixed cost and is unaffected by changes in prices or other inflationary effects. Therefore, it would be improper to reduce the cost of debt and impair the Company's ability to recover its authorized return on equity.

(3) The failure to account for the impact of inflation on other aspects of the Company's business, namely operating expenses and earnings, which impacts the Company to a much greater extent than any alleged increase in rate base.

(4) The failure to consider the Company's continued inability to actually earn its authorized rate of return, and thereby recover the inflationary component in the cost of equity.

(5) If inflation is considered, it must be based on inflation that is <u>expected to occur in the future</u>, not historic data. As Mr. Chaves explains, "[u]se of current bond yield [to estimate inflation] is consistent with finance theory, i.e., the efficient market hypothesis. Further, ... the best estimate of tomorrow's [inflation] is simply today's [inflation]." RUCO, however, improperly uses historic data from the period 2001 through 2007 to estimate future inflation.[95]

In its reply, Chaparral City will focus on two obvious flaws in the proposals to determine a fair value rate of return – one by RUCO, in perpetuating the error of Decision No. 70441, and one by Staff, by failing again to show that fixed debt requires an adjustment for inflation. Chaparral City will also address Staff's and RUCO's improper reliance on the U.S. Supreme Court's *Hope* decision to avoid meaningful use of the

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[95] Bourassa Rj. at 15-16 (citations omitted).

Company's fair value rate base. The inevitable conclusion in this reply is that if an "inflation" adjustment is again found to be appropriate, it should be no more than 100 basis points, based on the obvious fact that one-half of the fair value rate base is plant valued at its historic cost.

A. <u>RUCO's Inflation Adjustment is Anything But "Conservative"</u>

RUCO claims that its 200 basis point adjustment is "conservative" and necessary to avoid "double counting" inflation.[96] Actually, RUCO is again over-counting inflation. The fair value rate base is the average of OCRB and RCRB. By definition, the original cost of the Company's plant contains no inflationary component, as Staff has acknowledged.[97] Nor is RUCO's adjustment "conservative." The Company's RCRB is not based on the CPI or other measures of inflation; it is the current <u>value</u> of its plant based on its reconstruction cost.[98] That value is cut in half by averaging the OCRB with the RCRB to derive fair value. Moreover, the impact of inflation on rate base is significantly less than the impact of inflation on the Company's operating expenses.[99] While the Company opposes any inflation adjustment, RUCO's proposed 200 basis point reduction to the cost of equity is hardly conservative given that the record clearly supports reducing the inflation adjustment by one-half to account for the fact that one-half of the FVRB is plant valued at its original cost.[100]

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96 RUCO COC Br. at 10. The Company agrees that RUCO's recommended downward adjustment to account for inflation is consistent with Decision No. 70441, which decision Chaparral City has appealed.

97 *See* Fox Dt. at 7-8.

98 *See* Ex. A-11.

99 Bourassa Rb. at 24-26.

100 *See* Fox Dt. at 7-8; Bourassa Rb. at 18-19.

B. There Is No Correlation Between Chaparral City's Cost of Debt and Current Inflation

Staff correctly argues that the Commission left open the question of whether the cost of debt should be adjusted for inflation.[101] In the remand decision, the Commission concluded that there was insufficient evidence that the Company's cost of debt was impacted by inflation.[102] However, there is no more evidence of inflation impacting the Company's debt in this case.

The Company's long-term debt consists of low-cost bonds issued in 1997.[103] The bonds have a fixed interest rate (cost), which was, at the end of the test year, 5.33 percent.[104] The annual cost (i.e., interest) does not increase or decrease in response to inflation or other economic conditions, but is a fixed amount that must be paid to avoid default.[105] Thus, the Company's long-term debt cost (which constitutes over 80 percent of the Company's total debt) does not change due to inflation, and Staff has presented no evidence to the contrary. Instead, Staff's evidence is directed to the general impact of inflation on debt pricing, i.e., the impact that occurs when debt is originally issued.[106]

Therefore, the Commission is again left with insufficient evidence to adjust the debt portion of the WACC for inflation. Again, this illustrates that on the record before the Commission in this rate case, any inflation adjustment should lower only the cost of equity before weighting, and that such adjustment should be no more than 100 basis points. Moreover, if current inflation levels are considered, as argued by Staff, then the

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[101] Staff COC Br. at 3 (citing Decision No. 70441 at 36).

[102] Decision No. 70441 at 36.

[103] *See* Company Corrected Final Sch. D-2.

[104] *Id.*

[105] Bourassa Rb. at 20-21.

[106] Fox Dt. at 6-7.

adjustment should be no more than 42 basis points.[107]

C. The *Hope* "End Result" Test Does Not Apply In Arizona

Both Staff and RUCO try to cloak their arguments in the U.S. Supreme Court's decision in *Hope.*[108] RUCO dangles *Hope* as promising an "opportunity to earn an appropriate rate of return if the Company's management exercise good judgment and manages its assets and resources in a manner that is both prudent and economically efficient."[109] This is the same party that agreed that it was prudent to obtain an additional CAP water allocation, but recommends no cost recovery, and the same party that recommends taking away settlement proceeds because the Company settled a claim concerning the contamination of two wells rather than selling them. In any event, the evidence shows that Chaparral City is well-managed, efficiently run and in compliance with all applicable law and regulation.[110] Yet, the evidence also shows that Chaparral City was not given an adequate opportunity to earn its rate of return in the last rate case, and that it never has earned that return.[111]

Staff's reliance on *Hope* is more disturbing. Staff concluded its brief by criticizing the Company for ignoring the needs of its ratepayers.[112] Apparently, Staff is upset that, despite current economic conditions, the Company still expects a return commensurate with the risks it faces consistent with the U.S. Supreme Court's *Bluefield* decision so that the Company can continue to attract capital.[113] Furthermore, Staff unflinchingly

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[107] *See* Bourassa Rj. at 17-18 (estimating current inflation using Staff's methodology).

[108] *Fed. Power Comm'n v. Hope Natural Gas,* 320 U.S. 591 (1944).

[109] RUCO COC Br. at 9.

[110] Tr. at 312, 313 (Scott testifying); Scott Dt., Exhibit MSJ at 5-6.

[111] *E.g.,* Bourassa Dt. (Rate Base) at 3.

[112] Staff Br. at 9.

[113] *Id.*

concludes its brief by declaring that its recommendation "results in the setting of just and reasonable rates, balancing the needs of the Company and its ratepayers in the tradition of *Hope*."[114] In other words, according to Staff, the end justify the means, the very aspect of the holding in *Hope* that does not apply in Arizona.

In *Simms*, the first Arizona decision to address the *Hope* decision, the Arizona Supreme Court squarely rejected the "end result" test, holding that the Arizona Constitution requires the fair value of a utility's property to be found and used to set rates.[115] Thus, the adoption of the "end result" test in *Hope* did not alter the fair value standard imposed by the Arizona Constitution. As the Court of Appeals stated in *Chaparral City*, "[t]he Commission is required to find the fair value of the utility's property at the time of the inquiry and to use that finding in setting just and reasonable rates."[116] Moreover, "[t]he reasonableness and justness of the rates must be related to this finding of fair value."[117] The Commission cannot authorize rates that fail to produce a reasonable return on the fair value of the Company's property, and then use the *Hope* "end result" test to justify its actions, as Staff apparently believes.

IV. CONCLUSION

For the foregoing reasons, and those set forth in Chaparral City's initial brief on cost of capital and rate of return issues, Chaparral City urges the Commission to authorize a cost of capital off 11.5 percent and a WACC of 9.96 percent. Chaparral City further urges that the WACC be used as the rate of return and applied to the fair value of Chaparral City's property, in accordance with the fair value standard. No downward adjustment to either the cost of equity or the cost of debt is appropriate, and such an

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[114] *Id.* (emphasis added)

[115] *Simms*, 80 Ariz. at 150-51, 294 P.2d at 381-82.

[116] *Chaparral City* at 11, ¶ 14

[117] *Simms*, 80 Ariz. at 151, 294 P.2d at 382.

adjustment would undermine the use of fair value to set rates.

Alternatively, if a downward adjustment is made, it should apply to only the cost of equity, and should be no more than 100 basis points to account for the fact that one-half of Chaparral City's rate base consists of plant and property valued at their original (historic) cost.

RESPECTFULLY SUBMITTED this 27th day of February, 2009.

FENNEMORE CRAIG, P.C.

By ______________________
Norman D. James
Jay L. Shapiro
3003 North Central Avenue, Suite 2600
Phoenix, Arizona 85012
Attorneys for Chaparral City Water Company

ORIGINAL and thirteen (13) copies
of the foregoing were filed
this 27th day of February, 2009, with:

Docket Control
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Copy of the foregoing was hand delivered
this 27th day of February, 2009, to:

Teena Wolfe, Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Robin Mitchell, Esq.
Legal Division
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Michelle Wood, Esq.
Residential Utility Consumer Office
1110 W. Washington Street, Ste. 200
Phoenix, AZ 85007

Copy of the foregoing mailed
this 27th day of February, 2009, to:

Craig A. Marks, Esq.
10645 N. Tatum Blvd.
Suite 200-676
Phoenix, AZ 85028
Attorney for Pacific Life

By: Mary House
2170025.1